To: Robert Scott

From: Financial Institution Participants, Alternative Indices Study Group

Re: Response to Set of Principles

Date: September 10, 1999

Thank you again for participating in our meeting earlier this week. We found the meeting very productive as a means of enhancing our understanding of the positions of students and schools as we collectively work to reach a consensus recommendation for the Study Group in the limited time remaining.

This memo is to respond to the suggest that we provide you with our analysis of our most recent proposal, as put forward at the August 31st meeting of the Study Group, using the principles which you shared with the Group on September 1st.

We believe that when applied to any proposal, there will be some tension among some of the individual principles. We have noted some examples.

Our responses are as follows:

Principle 1 – Any change must be budget neutral to protect the taxpayers' interest.

The FFELP community participants' approach to determining the correct conversion from the existing T-bill based formula to one based on Commercial Paper or LIBOR has always been that any recommended conversion would maintain budget neutrality. The conversion formulas recommended by the FFELP community can be implemented at no additional cost to the taxpayer through the 2003 reauthorization and at no additional cost above the existing 91-day T-bill formula after 2003. Budget neutrality should be based upon the final CBO scoring analysis.

Principle 2 – Borrowers should benefit equally from any change.

Borrowers are currently benefiting from the low T-bill interest rate environment and the 1998 legislated 0.80% borrower rate reduction. By changing the index from the 91-day T-bill to one that reflects lenders' cost of funds, lenders will be able to more closely match fund their student loan portfolios. This will encourage lenders to remain in the program and take a long-term view on investing in and improving the infrastructure of this student loan program. Consistent lender participation and investment in the program will result in increased competition among lenders to attract borrowers and schools. Greater competition invariably leads to lower costs and better service for borrowers. In the past, lender competition has resulted in reduction of fees and repayment rates to students, a wide choice of lenders by schools and needed investments in technology to develop systems that better meet school financial aid administration needs. Investments in student loan servicing technology will reduce default rates thereby reducing the overall cost of the student loan program to the taxpayer. Students pursuing a higher education in the future will be assured of the continued flow of private sector capital to finance education through all economic cycles as well continued investments in service delivery.

Principle 3 – Lenders deserve to earn a reasonable return on their investment and risk.

Lender return has been reduced due to the 1998 Reauthorization and market conditions. Many lenders are not hedging against basis risk since it is not affordable. The final index change will have different effects among lenders. Under the lender formulas advanced by the FFELP community members, lenders are expected to earn returns over the long-term that are slightly lower than what they have earned in the past. Lenders are willing to accept slightly lower future earnings in exchange for a decrease in volatility in the spread between what they receive on their student loan assets and pay on their funding. Vigorous competition will ensure that borrower interest rates are kept to a minimum and services continually improve.

Principle 4 – There should be no increase in the complexity of the program.

Changing the index on which lender yields are based will not increase the complexity of the program to students, schools or lenders. It will only make raising capital more predictable for lenders. The change to a Commercial Paper or LIBOR index can be implemented by lenders in the same manner as past changes to the T-bill based formula.

Principle 5 – Any changes should not detract from the goals of the second study.

The goals of the second study are set forth in section 801 of the Higher Education Act. Implementation of a market-based index is consistent with the second study's mandate to establish a market-based mechanism to determine loan pricing. Lenders are committed and eager to create a stronger and more rational industry structure.

Principle 6 – The recommendation should affect the long-term as well as the short-term.

During the anticipated applicability of the revised reference rate formula (through June 30, 2003), more than $55 billion in FFEL loans are expected to be made. These loans have an average life of at least eight years, and some will be outstanding longer. Even if a permanent change in the law is not feasible at this time, a change through June 2003 would represent a positive step towards improving the FFEL Program as we face the significant challenges of the future.

Viewed more broadly, the adoption of a modern reference rate formula will help assure the continued participation of a broad diversity of lenders and other loan providers. This will set the stage for increased market competition well into the future. This market competition will benefit students in the of better customer service and rate competition.

Principle 7 – The recommendation should not detract from a healthy, competitive market for student loans.

A change in the lender index will reduce the uncertainty associated with match funding student loan portfolios under the current T-bill indexed formula. More stable and predictable match funding will encourage lenders to remain in the program and take a long-term view when considering investments to maintain and improve the infrastructure of the student loan program. From 1990 through 1997, the number of lenders participating in the FFELP student loan program declined by over 50 percent. A change in the index will help stem the decline in lender participation and increase the competition among lenders.

Principle 8 – Any change recommended should be consistent with the structure of the loan industry in terms of liquidity and volatility.

The relatively unstable relationship between T-bill rates and student loan providers' funding costs has had a significantly negative impact on FFELP participants' abilities to match fund their portfolios. By switching to a market-based index and reducing the unnecessary capital markets uncertainty that accompany the T-bill index, predictability and certainty in the FFEL program can be enjoyed at no additional cost to students, schools or taxpayers. A change to a lender index based on Commercial Paper will greatly enhance liquidity to FFELP participants by reducing the funding volatility associated with the legacy T-bill index.

Principle 9 – The timing of changes to FFELP/DL should be made at a logical and manageable time of the year for all parties involved (lenders, schools, students), and the changes should be communicated in a systematic manner to all parties involved.

Changing the index on which lenders are compensated will not affect students or schools. In fact, as competition between lenders increases, borrowers and schools should benefit over time from program improvements.

Lenders will be required to make modifications to their loan servicing systems and they along with their loan servicers have sufficient expertise to make such modification within a relatively short time frame. Servicers historically have made numerous changes due to revision in the laws and regulations governing guaranteed student lending. Any changes, of course, would be carefully coordinated with the Department of Education.

Principle 10 – Both FFELP and DL borrowers should have an equal opportunity to benefit from any financial changes to FFELP.

As indicated above, legislated student rates will not be impacted by a change in the lender rate. Some differences in the FFELP and DL programs exist but they are unrelated to the lender interest rate index.